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TRADING, INVESTING AND SPECULATING

NOTE THE DIFFERENCE

TRADING is "distinctly" different from investing as a trader has a different mindset and approach compared to an investor.

The only problem is many of us start our share purchase as traders, but the trading buy ends up as an investment. The motto should be — never turn a trade into an investment. You must make the distinction between a trade and an investment.

It all boils down to the process of buying a stock. Before buying, it is good self-discipline to declare whether we are buying that stock for trade or investment. You see, the thought process and the sell decision process are different for both, and the sell decisions are triggered by different circumstances.

A "trade" means that you are buying the stock in anticipation of a certain event or for a particular reason that is expected to drive the share prices higher. The event or reason could be that a takeover is expected to be announced, or a huge contract is anticipated to be secured or a bumper dividend is about to be announced. In fact, the anticipation could be about anything material that would increase the stock price.

With a "trade" trading mindset, we buy a stock for a reason or catalyst. Then one of two things could happen. The event pans out as expected but there is no price increase or, worse still, the share price tanks. The same scenario may crop up as well if the reason does not materialise as anticipated.

This is when there is a real danger that the trading stock may end up as an investment stock. When there is an accompanying share price drop, we may end up saying, "well, since the share price is lower, I will wait for it to break even or maybe average down".

We hold on to the thinking of "what is the worst thing that can happen..." Lots of things can happen. Often, they are bad things. The rule of thumb is that you bought the share for a reason (or catalyst) and since the reason did not happen or if it happened, did not have the desired price effect, you should sell immediately.

There is no reason for you to hold on to the share. Remember, if not for the reason (or catalyst), you would not have bought it in the first place.

Never buy a stock for trade when there is no reason (or catalyst). Never buy a stock for trade premised on a hope that the share price will go higher. In fact, never hang on to a stock solely on the premise of hope. Hope should have no place in your investment decision.

The mindset of an "investor" is that they start off buying a small amount of a stock. They then hope the market will mis-price the stock lower so that they can buy more. All their purchases are made based on their idea of the intrinsic value of the company.

When the market gets pessimistic, it allows investors to purchase stocks at reasonable prices relative to their future potential. The lower the intrinsic value, the more compelling it is to buy. You buy down when investing. The investor would only sell when the stock price is close to, at, or above the intrinsic value.

On the contrary, traders cut their losses immediately if the reason for the trade does not pan out.

Then there is the money we use for pure unadulterated speculation (or punting). No basis is required for this kind of speculating — no reason (or catalyst), no notion of intrinsic value. In fact, some allocate their funds for share purchases into three pools: for trading, for investing and for speculating.

Speculating meets the need of the inherent gambling instincts that some (or many) of us have. The funds set aside for this purpose is small, say five to 10 per cent. We should be prepared to let these funds dissipate if things go wrong. In fact, it is good to start with, "I am prepared to lose all of this. It will not cause a dent in my future".

The distinction between trading, investing and speculating should be appreciated. It will sober our forays into the stock market.

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The writer is chief executive officer of Minority Shareholders Watch Group